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## The IMF: A cure or a curse?

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### Abstract:

*Just one year ago, the IMF praised parts of Asia as a model for the world's emerging markets. Now, it blames the region's financial crash on poor domestic policies and insists on stringent, sweeping changes. A look at the IMF's history suggests it could use a little structural adjustment of its own.*

### Full Text:

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In November 1996, an International Monetary Fund (IMF) publication reporting on an IMF-sponsored conference in Jakarta trumpeted, "ASEAN's Sound Fundamentals Bode Well for

Sustained Growth." The central message of the conference, it stressed, was that "the region is poised to extend its success into the twenty-first century and that governments still have a major role in driving this process.... Participants' confidence... was rooted in the region's strong macroeconomic fundamentals; in ASEAN's (Association of Southeast Asian Nations) tradition of, and commitment to, efficient allocation of investment; and in the widespread belief that the external environment will continue to be supportive."

If the IMF was publicly confident about the strength of Asia's "fundamentals," it was even more enamored with the virtues of the international capital movements that were helping fuel the region's remarkable growth. Even as Asia's ongoing economic crisis began to unfold in the summer of 1997, the IMF was strongly pressing its members to amend its charter (for just the fourth time in its 53-year history) to make the liberalization of capital accounts a specific goal of the fund, and to give it "appropriate jurisdiction" over capital movements.

It took less than a year for the IMF to decry Asia's "fundamentals" as severely wanting. The crisis, it argued, was "mostly homegrown." Instead of urging the prompt dissolution of capital controls, IMF managing director Michel Camdessus began calling for "orderly, properly sequenced and cautious" liberalization of government controls on money flows in and out of countries.

The mistakes of the past, however, did not deter the IMF from intervening in Asia's crisis countries with unprecedented zeal. But if the IMF'S predictions about Asia were so wrong, why should its prescriptions be any better? Do they flow from a technocratic diagnosis? Or do they merely mask the institution's own interests and those of its controlling owners? For that matter, just exactly whose interests does the IMF represent? Its actions during the Asian financial crisis not only cast the answers to these questions in sharp and disturbing relief, but also raise serious doubts about the soundness of the

institutional architecture for global governance in general, and for international economic and financial management in particular.

## LETTING THE RECORD SPEAK

If the IMF had a dollar for every criticism of its purpose and role by the Right, the Left, and the Center, it would perhaps never again have to approach its shareholders for more money to sustain its operations. Countless Wall Street Journal editorials have denounced the institution's "bailouts" and tax-raising proposals as efforts to prop up "bloated" states. Left wingers claim that the fund's policies are a not-so-thinly-disguised wedge for capitalist interests—a view underscored by former U.S. trade representative Mickey Kantor's colorful rendering of the institution as a "battering ram" for U.S. interests. A more banal interpretation portrays the IMF as a hapless Wizard of Oz figure, "a mythologized contraption through which weak human beings speak," to use one observer's words, whose effects are far more limited than its champions and its critics would have us believe.

The IMF's actual record is helpful in sorting out these many overblown and conflicting claims. Founded in 1944 (see box on next page), the institution played a modest but important role in maintaining stable exchange rates in its first two decades. This *raison d'être* collapsed after 1971, when the major currencies moved to a floating exchange rate system. Since then (and especially after 1978, when the second amendment to the IMF's charter formally ratified the move to floating exchange rates), its engagement with industrialized countries has been largely *pro forma*. By the beginning of the 1980s, with commercial bank lending in high gear, the IMF's clientele had shrunk to those poor countries to which no commercial bank was willing to lend.

Until the mid- 1980s, fund programs in these poor countries were relatively narrow and generally of short duration. Loan conditions focused on currency devaluations, budget cuts, higher taxes, and curbs on the supply of credit in the economy. Naturally, however, there was no shortage of criticism. Nationalists of all hues lamented the loss of sovereignty entailed by the requirements of IMF programs. More tellingly, critics questioned the fund's single-minded attention to budget deficits, particularly its tendency to ignore the political realities that led governments to cut politically expedient expenditures (funds for primary education, for example), while protecting more politically powerful interests (those of the military and university students). By the same token, governments desperate to meet IMF-mandated targets often chose to impose tax increases that followed the path of least political resistance—raising sales taxes instead of property taxes, for example.

In short, criticisms of fund programs frequently served to mask the actions of the same politicians and policymakers who were largely responsible for their countries' predicaments. Despite the IMF's best intentions, the realities of local politics often resulted in outcomes that were socially regressive, economically myopic, and only modestly able to put a country back on a sustainable growth path. A burst of IMF programs in Africa at the end of the 1970s, for example, proved singularly ill-advised for a continent whose economic problems stemmed from deep-rooted political and social causes. Then again, fund programs significantly helped countries that had viable institutional infrastructures and were willing to implement tough decisions (such as India, Indonesia, South Korea, and Thailand in the 1970s and 1980s).

## THE DEBT CRISIS: A HISTORICAL PIVOT

The advent of the Latin American debt crisis in 1982 marked a major turning point for the IMF's fortunes. Navigating skillfully through uncharted waters, the fund helped to forestall the dangers posed

by the crisis to the global financial system. But its role in the debt crisis also had two important long-term consequences for the institution. First, it became the equivalent of a debt collector for commercial banks. Second, the IMF expanded its mandate to promote structural reforms.

### The "Creditor Community's Enforcer"

Although both debtors and creditors shared blame for the 1980s debt crisis, the costs of adjustment were borne asymmetrically by debtor countries, which suffered their worst economic decline since the Great Depression. Even as the fund's programs grew in number, its net lending shrank. Particularly embarrassing for the IMF was the contrast between the late-1980s increase in repayments by Latin nations and the further contraction of their economies. Describing the IMF as the "creditor community's enforcer," former Columbia University professor Karin Lissakers (now the U.S. executive director at the IMF) noted that the behavior of "a political organization" such as the IMF "raises the question of which way will its biases go" when placed between debtors and creditors. Denunciations by MIT professor Stanley Fischer (currently the IMF's first deputy managing director) of the institution's "mistaken debt-relief strategy" were seconded by Jacques Polak, a respected former research director and later the Dutch executive director, who complained that the institution was "being used by the commercial banks in the collection of their debts."

This debt-collector role inevitably undermined the institution's credibility. Its economic projections, for example, became malleable to major shareholder pressure (see box above). As former Federal Reserve chairman Paul Volcker once bluntly said of the IMF's numbers in the debt crisis, they were "negotiated" numbers, embracing in some instances what former IMF research director Jacob Frenkel called "considerations other than purely analytical ones." Indeed, if "the record shows that frank and open debate does not take place in official and banking circles" (to use Fischer's 1989 characterization of the Bretton Woods institutions' behavior in the debt crisis), a decline in client trust is inevitable.

### The Advent of Structural Reforms

A second consequence of the debt crisis was that the IMF, chastened by the modest results of its programs and pressed by its critics, reformulated its approach. Rather than focus just on the size of budget deficits and the magnitude of revenue increases and the expenditure cuts needed to correct them, the fund began to demand specific cuts and increases for example, pressing some countries to protect social programs and prune military spending. As the economic travails of Africa and the IMF's very limited success there became evident, fund programs became even more detailed. To counter criticisms that its policies hurt the poor, or its bias toward austerity and exports encouraged environmental destruction, the fund added poverty alleviation and governance-related issues (such as corruption) to its agenda—a trend reinforced by the East European countries joining the fund at the end of the 1980s. In many cases, the IMF devised loan conditions at the behest of borrowers, whether local officials who felt powerless to sway their political leaders or politicians who used the IMF to shield themselves from popular rejection of policies that they too recognized as essential.

Although there was more rhetoric than reality to these changes in the fund's approach, its loan conditions were clearly moving beyond merely requiring fiscal and monetary adjustments. An equally clear and more troubling trend implicit in the IMF's mission creep was its growing hubris. Spurred on by the demands of its principal owners and the internal activism of its technocrat managers, the fund began to assume that all that was deemed good for a country should also be part of its mandate. As a result, its overlap with its Bretton Woods sister, the World Bank, grew. And with the major powers holding a "very pro-Fund view" relative to the World Bank (again, to use Fischer's words), the advice

emanating from the Bretton Woods institutions began to have an increasing IMF flavor.

## MEXICO 1994: A MODEL CRASHES

The aftermath of the 1980s debt crisis led to a consensus among policymakers that less developed countries (LDCs) should place greater reliance on market forces. When coupled with sound macroeconomic policies (especially low budget deficits), liberalized financial markets would produce stronger growth and enable the self-correcting mechanisms of market discipline to work. Countries such as Mexico, which sharply reduced their budget deficits, privatized state-owned enterprises, and welcomed foreign investment, were praised and rewarded by the fund and Wall Street as star pupils who could do no wrong. Evidence to the contrary was ignored or pooh-poohed by an IMF determined to uphold and spread its model of economic reform. So when financial crisis hit Mexico in December 1994, the IMF (not to mention Wall Street, the media, and most academic analysts) was, to put it mildly, caught offguard.

The massive \$40 billion financial package that the IMF organized for Mexico in 1995-at the time its largest package ever-was only possible because Mexico borders the IMF's largest shareholder. The package prevented a default and allowed Mexico to regain access to financial markets, while limiting the impact of the crisis on other countries in the region. But it also set a precedent. At the very least, it held out the likelihood that foreign creditors could expect to be bailed out in similar situations. And although several recent commentaries have hailed the IMF's intervention as a "success," such a characterization glosses over the somber reality that real wages in Mexico are still one-quarter below their pre-crisis levels of more than three years ago.

The IMF's postmortem of the Mexican crisis concluded not that the fund was wrong, but that it lacked the wherewithal to be right. It identified a generic problem afflicting LDCs-a lack of transparency-and asked its shareholders for additional policing powers and resources to correct it. Persuading nations to make more financial information available to international institutions such as the IMF (and to the public) would doubtless help avert or defuse crises. But there are limits to this approach. Even if the IMF had more relevant information, it would have to remain discreet in the face of an emerging problem, since financial markets have a tendency to make even not-so-dire predictions by such institutions self-fulfilling. And the more information that the IMF asks for, the less countries are likely to be able to provide it, at least within the rapid time frame that markets move, and especially when global money managers sense looming problems. Finally, it is not the availability of information that matters per se, but its interpretation. There are none so blind as those who will not see; and staring at the proverbial pot of gold can be blinding.

A more curious response to the peso crisis was the fund's enthusiasm for unfettered global financial markets. That global financial markets bring high risks and high rewards is well established. But since the poor have less capacity to bear risk, the IMF might have been expected to move cautiously in integrating poor countries into global financial markets, despite the high potential rewards. As Larry Summers put it when he was chief economist at the World Bank, in banking as in nuclear plants, "free entry is not sensible." But arguing that the benefits of free capital movements were substantial, the fund began its campaign to bring the promotion of capital account liberalization under its mandate and jurisdiction barely a year and a half after the Mexico crisis. Of course, another factor behind the fund's views may have been the sentiment subsequently expressed by Summers in his current capacity as deputy secretary of the U.S. Treasury: namely, that: "financial liberalization, both domestically and internationally is a critical part of the U.S. agenda."

## ASIA 1998: DEJA VU WITH A DIFFERENCE

The consequences of the IMF'S experience in earlier crises are manifest in its unfolding role in the Asian crisis. As before, the fund's diagnosis has emphasized the internal roots of the problem: the failure to control large balance-of-payments deficits; the explosion in property and financial markets; mismanaged exchange rate regimes; rapidly expanding financial systems that were poorly regulated; and an unwillingness to act decisively once confidence was lost.

But, as in the past, the fund's focus on in-country factors has deflected attention from both its earlier firm endorsement of these countries' policies and its unbridled cheerleading on removing the barriers impeding globalization. Indonesia, Korea, Malaysia, and Thailand had thrived for years, despite weak financial systems and numerous destabilizing external events, including the oil shocks of the 1970s and the soaring dollar of the early 1980s. And, yes, crony capitalism had thrived as well-if anything, in a rather transparent way. Now the IMF and international capital markets claimed they were shocked, just shocked, to find that the regime's impressive economic achievements were built on such dodgy foundations.

The countries did make egregious mistakes-perhaps the worst was their overconfidence that their success was somehow uniquely based on quasi-magical "Asian values." In reality, their economies were undone not by visible internal flaws, but by the unforeseen impact of the global capital flows that the IMF sought to set free. The conventional macroeconomic indicators of the Asian crisis countries were well within prudential norms. These were not profligate governments whose policies yielded large deficits and inflation. Current account deficits in Thailand were extremely high, but that was hardly a secret. In hindsight, there were cracks in exchange rate regimes, especially in Korea and Thailand; yet they were not apparent at the time, and exchange rates were not excessively overvalued. But the combination of huge capital inflows with high domestic savings rates tempted inexperienced business executives and corrupt and incompetent politicians, particularly when the state implicitly stood behind the financial speculations of private institutions.



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## MOUTH-TO-MOUTH RESUSCITATION

When a domestic asset bubble bursts, the consequences can be painful. Capital flight severely amplifies the pain. In the case of the Asian crisis, a vicious circle set in. As capital flooded out, exchange rates collapsed, and a wave of bankruptcies by firms unable to pay their foreign debts engulfed the private sector, leaving the countries at the mercy of panic-stricken private lenders and obdurate official ones.

The IMF assembled a mammoth financial package-\$17 billion for Thailand, \$43 billion for Indonesia, and \$57 billion for Korea-with resources drawn from the IMF itself, together with the World Bank, the Asian Development Bank, and leading governments. Despite the poor judgment shown by financial markets (differences in interest rates between Asian and U.S. sovereign debt, a measure of the relative risks that markets attached to these countries, had continued to narrow until the first half of 1997, shortly before the crisis), resources disbursed by fund programs have been used by the crumbling Asian economies to pay off foreign creditors.

But the disbursements were linked to the countries' meeting a range of conditions that seem to go well beyond the IMF's mandate. Two decades ago, fund programs typically imposed a dozen or so requirements or strictures. But the Asian countries have had to sign agreements that look more like Christmas trees than contracts, with anywhere from 50 to 80 detailed conditions covering everything from the deregulation of garlic monopolies to taxes on cattle feed and new environmental laws.

Many of the objectives underlying these conditions are laudable. Unfortunately, they also reflect a troubling lack of institutional self-restraint. According to fund sources, conditions such as the one asking Korea to speed up the opening of its automobile and financial sectors reflected pressures from major shareholders (Japan and the United States). In Indonesia, detailed conditions related to the banking sector were imposed despite the fund's limited expertise in this area. In November 1997, the Indonesian government shut 16 banks at the IMF's insistence without providing firm assurances that the government would stand behind those banks that remained. The resulting bank run almost dragged down the entire Indonesian banking sector. By the IMF's own admission, a fragile system was pushed over the brink-a tragic illustration of the folly of institutional overreach.

## RESTORING THE BALANCE

Against the backdrop of the IMF'S history of the last 50 years, the Asian financial crisis suggests four conclusions:

The first and most evident conclusion is that, as Federal Reserve chairman Alan Greenspan remarked recently, the global financial system seems to facilitate "the transmission of financial disturbances far more effectively than ever before." Many analysts now share the view that foreign financial flows should be regulated in some way. The question is how to make openness to the world's capital markets less perilous. Although LDCs undoubtedly need to open up to the world's capital markets, they would be well advised to do so at a pace commensurate with their capacity to develop sound regulatory and institutional structures. In particular, tighter limits on short-term foreign borrowing-specially by banks-may well be essential.

This need for greater prudence on the part of LDCs is underscored by the failure of various proposals designed to protect nations from the full force of global financial flows (such as a tax on international financial transactions or financier George Soros's suggestion for a publicly funded international insurance organization). In theory, when a financial crisis does occur, there should be an international equivalent of domestic bankruptcy codes that would create a legal venue for creditors and debtors to

resolve their differences, and allow both sides to avert financial panics and to stop shirking their responsibilities. But the major actors in international financial markets dislike the idea. Perhaps this is because they are aware that more pressure can be brought onto LDCs through the IMF than through a judicial "due process." Barring much greater losses in major industrialized countries, support for any of these proposals is unlikely.

A second conclusion is that "moral hazard"-the propensity in both borrowing countries and creditors to take excessive risks because of the implicit insurance offered by bailouts-applies to the IMF as well as to borrowers and creditors.

In the case of borrowers, costs to their citizens and polities vastly exceed financial inflows from the bailouts. Thus, to say that borrowing countries will misbehave in hopes of being "bailed out" is to miss the point. The hazard (moral or otherwise) is that LDC leaders will use the IMF and other external forces to steer domestic discontent away from their own machinations. There is perhaps greater "moral hazard" among creditors, particularly in the banking segment of the financial sector-a subject much commented on in recent years.

More worrisome is a certain moral hazard on the part of the IMF and its major shareholders. The steady expansion of institutional objectives (and loan conditions) has occurred because borrowing countries bear a disproportionate share of the political, economic, and financial risks of IMF programs. There is little downside to these programs for the fund's major shareholders, its management, or staff. Financially, IMF-led bailouts impose few net costs on the industrialized countries, since the fund has always been repaid (with the exception of Sudan, arrears to the IMF exist only in the case of countries that have imploded). The damage resulting from the IMF's mishandling of the Indonesian banking sector was entirely borne by the country-not by the IMF or the board that had signed onto these conditions. The IMF's apex role among multilateral financial institutions means that it is the first to go into crisis countries-but also the first to get out-further reducing its financial risks. Instead of underscoring the fund's limitations, the various crises that have afflicted LDCs have enlarged its resources and mandate, an aggrandizement driven by the bogeyman of "systemic" threats to the world's financial system.

If the financial risks are few for the IMF, the political risks are even fewer. The fund is largely irrelevant to managing economic relations among major economic powers. As a result, its member countries are divided into "structural" creditors and debtors, with the latter group comprising LDCs and, more recently, countries making the transition from central planning to market economies. With this division, the essence of the institution as a cooperative has dwindled. Knowing that they were unlikely to borrow from the IMF, the major economic powers have had fewer qualms about continually expanding its power and role. For example, many European members of the IMF signed on to conditions calling for greater labor market flexibility in Asia without pausing to reflect on the situation in their own countries, where extremely rigid labor markets have resulted in soaring unemployment. This contradiction has less to do with an apparent double standard than with the unlikelihood of many European nations ever being subject to IMF strictures.

A third conclusion is that the continued expansion of the IMF's power and mandate is bad for debtor nations, for the global financial system, and, ultimately, for the IMF itself. The increasing scope of loan conditions implies that during a financial crisis, the IMF should take over more and more of a country's decision-making process, without any commensurate increase in accountability. Put in a different way, the absence of risk sharing means that these conditions amount to a form of political taxation without representation.



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Moreover, in today's financially rooted economic crises, expanding the IMF's agenda (and its associated loan conditions) can be selfdefeating. Unlike the slow burning "old style" economic crises caused by macroeconomic imbalances, financial crises can spread globally like wildfire. Quick and decisive action is necessary to bring them under control. The widening of loan conditions invariably results in a loss of precious time, whether during negotiation or implementation, making a bad situation worse.

The long-term damage to the IMF itself should also not be underestimated. In the absence of rules designed to ensure self restraint, its stafflike that of any other bureaucracy-will always push the fund toward policy prescriptions that give them greater prominence and influence. Observers of governmental bureaucracies have long recognized that a multiplicity of missions impairs bureaucratic effectiveness and erodes institutional autonomy. The IMF's widening agenda has made it both less effective and more vulnerable to politicization, thus tarnishing the technocratic reputation that is essential to the credibility of its prescriptions. As its goals increase, the criteria for "success" become more elusive, leading the institution to tout its own "achievements" ever more ardently-with discrediting results, as demonstrated by the debt crisis in the 1980s, and again by the 1994-95 Mexican peso crash.

The final conclusion is that by placing the onus of adjustment solely on debtor countries, the fund's actions relieve any pressure on creditor countries to change the status quo, whether the creaky architecture of international organizations set up 50 years ago, an exchange rate regime whose gyrations trap weaker countries, or the increasingly ineffective regulation of international finance. Today, the principles for which the IMF claims to stand are increasingly at odds with the way in which it conducts its own affairs. It promotes the virtues of democracy-while deeming them impractical, if not downright dangerous, for multilateral governance. It derides and discourages state intervention in economic affairs-while insisting on its right to restructure from top to bottom the economies of the LDCs. And it rejects the need for international controls on capital as invidious-while asserting the need for those on labor to be obvious.

This welter of contradictions serves to highlight the corrosive impact of a long series of ad hoc solutions on an increasingly dilapidated system of global governance. Ultimately, the limitations of multilateral institutions such as the IMF reflect the limitations of those nation-states that created them. And, if as a normative principle power should go hand-in-hand with responsibility, then those states with the most power in these institutions must bear the blame for their failings and assume the greatest responsibility for their rejuvenation.

## WANT TO KNOW MORE?

For views on the IMF's role in international monetary cooperation, see Harold James' *International Monetary Cooperation since Bretton Woods* (Washington: IMF and New York: Oxford University Press, 1996) and Margaret Garritsen de Vries' *Balance of Payments Adjustment, 1945 to 1986: The*



IMF Experience (Washington: IMF, 1987). A more recent perspective on the IMF's mandate is Michel Camdessus' speech, "The Role of the IMF: Past, Present, and Future" (Washington: Annual Meeting of the Bretton Woods Committee, February 13, 1998).

Two balanced treatments of IMF programs in developing countries are Tony Killick's *IMF Programmes in Developing Countries: Design and Impact* (London; New York: Routledge, 1995) and Graham Bird's *IMF Lending to Developing Countries: Issues and Evidence* (London; New York: Routledge, 1995).

The classic book on IMF conditionality is John Williamson, ed., *IMF Conditionality* (Washington: Institute for International Economics, 1983). An elegant treatment of the evolving nature of IMF conditionality by a former senior official is Jacques Polak's *The Changing Nature of IMF Conditionality* (Princeton: Princeton University Press, 1991). A more recent institutional perspective can be found in Manuel Guitian's "Conditionality: Past, Present and Future" (Washington: IMF Staff Papers, December 1995).

There are innumerable critiques of the IMF. A sampling from the Right can be found in Doug Bandow and Ian Vasquez, eds., *Perpetuating Poverty: The World Bank, The IMF, and the Developing World* (Washington: Cato Institute, 1994). A representative collection of critiques from the Left is Kevin Danaher, ed., *Fifty Years Is Enough The Case Against the World Bank and the International Monetary Fund* (Boston: South End Press, 1994).

Readers interested in more on the origins of the Asia crisis should consult Steven Radelet and Jeffrey Sachs' "The Onset of the East Asian Financial Crisis" (Cambridge: Harvard Institute for International Development, March 1998).

For a thoughtful fund perspective on its role in the Asia crisis, see Stanley Fischer's "The IMF and the Asian Crisis" (Forum Funds Lecture at uCLA on March 20, 1998). On the World Bank's role, refer to Joseph Stiglitz's "The Role of International Financial Institutions in the Current Global Economy" (Address to the Chicago Council on Foreign Relations, February 27, 1998). Critical viewpoints include, Allan H. Meltzer's "Asian Problems and the IMF" and Charles W Calomiris' "The IMF's Imprudent Role as Lender of Last Resort," (Cato Journal, Winter 1998) and Martin Feldstein's, "Refocusing the IMF" (Foreign Affairs, March/April 1998).

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#### [Author note]

DEVESH KAPUR is an assistant professor at Harvard University and the author, with John Lewis and Richard Webb, of *The World Bank: Its First Half Century*, two volumes (Washington: Brookings Institution Press, 1997).

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